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June 23, 2014

CONFIDENTIAL

The Honourable Kevin Sorenson
Minister of State (Finance)
Department of Finance Canada
pensions@fin.gc.ca

RE: Response to Department of Finance Canada's Consultation Paper, *Pension Innovation for Canadians: The Target Benefit Plan.*

Dear The Honourable Kevin Sorenson,

Thank you for the opportunity to submit our response to the Department of Finance Canada`s Consultation Paper, *Pension Innovation for Canadians: Target Benefit Plan.* Our comments are attached. This is an area in which our actuaries have spent considerable time and effort. We believe that Target Benefit Plans represent an important step forward in the evolution of pension plan design and we want to ensure that they are implemented as effectively as possible.

Please do not hesitate to contact Fred Vettese (416-383-6454 or fvettese@morneaushepell.com) should you require any further detail on the points made in our submission.

Sincerely,

(*Original signed by*)

Fred Vettese
Chief Actuary

(*Original signed by*)

Mel Bartlett
Managing Partner, Atlantic Canada

TABLE OF CONTENTS

INTRODUCTION

Morneau Shepell commends the Department of Finance on its proposal to introduce Target Benefit Plans (TBPs). The long-term sustainability of the traditional DB plan is very much in question and yet DC plans, the only real alternative until recently, have their own drawbacks. The time has come for a new hybrid vehicle that shares risk between employers and employees in a more sustainable manner, while preserving some of the more attractive features of DB plans. In our opinion, TBPs are very promising in this respect.

There are many ways to design a TBP and in general we support the framework proposed by the Department of Finance. We are pleased to note that many of the provisions in the Department's consultation paper reflect the ground-breaking work that was carried out in New Brunswick and Prince Edward Island with the help of Morneau Shepell's actuaries. While this submission sets out the details of our position on the various questions posed in the consultation paper, we do want to preface it by highlighting several key issues.

First, we caution that the level of benefit security within a TBP has to be appropriate, meaning neither too high nor too low. The problems with too low a level of security are obvious. Trying to achieve a very high level of security is also problematic, however, since it brings with it some undesirable side effects. If we foster the notion that benefits are practically guaranteed, then any future reduction in benefits will be met with shock and anger. We have to remember that TBPs are not DB plans. If plan participants are made fully aware of the possible variability in benefits, then that variability ends up being much less of an issue when it does arise. We have seen this with DC plans and also in other countries, such as Denmark, that have been experimenting with TBP-like plans of their own.

The other problem with aiming for too high a level of benefit certainty in a TBP is that it exacerbates the inevitable problem of achieving intergenerational equity. It results in benefits to current participants being lower than they might otherwise achieve; it would be a future generation that enjoys increased pensions or lower contributions at the expense of the current generation. This is not to say that a funding buffer is unnecessary, but it should not be excessive.

We highly applaud the proposal to allow a retrospective adoption of TBPs, subject to a transition period. Without this, we believe that employers that decide they cannot maintain their DB plans any longer would go straight to DC, which is a less favourable alternative for most employees than TBP. We acknowledge that individual rights need to be preserved and that, in any retrospective conversion, member consent may be needed, but the rules for what constitutes an adequate level of consent cannot be so onerous as to make TBPs impractical to implement.

Another key aspect of TBPs is the governance structure. The proposed approach requires a joint governance structure with a Board of Trustees or similar body in all cases. While this is appropriate in multi-employer and largely unionized single-employer environments, it may not always be practical in largely non-unionized single-employer environments where no bargaining agent(s) represents the bulk of plan members. In these cases, we suggest that, in lieu of requiring joint governance, consideration be given to introducing other mechanisms to ensure interests of plan members are protected in the operation of the TBP. This will also have the benefit of making TBPs a viable alternative for non-unionized single employers that do not want to adopt a joint governance approach. We note DC plans carry far more risk for plan members than TBPs but do not require joint governance.

We note that one seemingly minor provision of the proposed TBP framework – the benefit on termination of employment – may largely mitigate the effects of a future funding crisis such as we experienced in 2008/9. The funding deficits arose not only because of losses in the capital markets but equally because low bond yields caused commuted values to spike. The latter problem virtually disappears when termination values are determined on a going-concern basis. This is a very important and highly positive feature of TBPs.

The final point before proceeding to the main body of our submission is to stress the importance of simplicity and transparency. If we believe that mid-sized employers should also be able to adopt TBPs, then we cannot make compliance too difficult or too costly. To that end, some simplifications are recommended, such as using a going-concern funding basis with a PfAD rather than adopting a probabilistic approach.

With these points in mind, Morneau Shepell appreciates the opportunity to share its thoughts on the questions raised in the Department of Finance's consultation paper. The undersigned would be pleased to address any questions that arise from this submission.

Respectfully submitted,

(*Original signed by*)

Fred Vettese,
Chief Actuary

(*Original signed by*)

Mel Bartlett,
Partner

ADMINISTRATION AND GOVERNANCE

The federal TBP governance framework should be designed so that there will be a high level of assurance of compliance with laws, regulations and the terms of the plan text. Moreover, decision-making should reflect the risk sharing goals and that employers, members and retirees all have separate interests that need to be effectively represented.

CONSIDERATIONS

A number of considerations should be reflected in the choice of a federal TBP governance framework:

Duty to plan parties: The administrative body of the TBP should have the capacity to make decisions in the interest of the employer, plan members and retirees. The risk that plan administrators find themselves in a conflict of interest situation should be minimized.

Representation: The extent to which the federal governance structure of TBPs would differ from those of federally-regulated DB plans will depend on the allocation of risks between the parties. Given the shared risk nature of TBPs, all parties that bear the risks under the plan (including active members, retirees and other beneficiaries) should participate in the governance.

Regulatory flexibility: The importance and role of the administrative body will depend on the extent to which the TBP legislative and regulatory provisions are prescriptive. A flexible federal regulatory framework allowing for discretion in important decisions in respect of the plan would require a framework that sets out clearly the responsibilities of the governance body and the accountability mechanisms.

Effective decision making: The administrative body should be capable of making decisions in a timely manner, avoid any deadlocks and have adequate mechanisms at its disposal to resolve any differences or disputes.

Unionized environment: Given that some aspects of a federal TBP governance framework may be negotiated as part of a collective agreement, the interest of retirees and other plan beneficiaries who are not involved in the collective bargaining process would need to be adequately protected.

PROPOSED APPROACH

The approach proposed for the federal TBP governance framework is a joint governance structure that would involve the participation of the employer(s)/sponsor(s), active members, retired members, other plan beneficiaries and allow for independent participants (e.g., pension experts or professionals).

GOVERNANCE POLICY

Federally-regulated TBPs would be required in federal legislation to develop a governance policy. The plan sponsor would be required to inform plan members and other beneficiaries about the policy, which would be made available to them upon request. The federal legislative provisions would set out that the governance policy would be a stand-alone document or part of the plan text.

Among other things, the policy would set out:

- the composition of the governance body (board of trustees or similar body), including its size and the level of representation from each party;
- the process for appointing (and removing) administrators (i.e., members of the governance body), including the chair, and the duration of their terms;
- the voting process and rules (e.g., required majority), including how deadlocks are broken;
- a detailed description of the roles and responsibilities of administrators;
- the composition and functions of Board committees, if any;
- the skill set required from a certain number of members on the Board (e.g. investment, actuarial, etc.);
- conflict of interest rules;
- an administrator code of conduct;
- disclosure requirements in addition to those set out in regulations; and
- remuneration and expense policy for administrators.

NATURE AND COMPOSITION OF THE ADMINISTRATIVE BODY

Federally-regulated TBPs would be administered by a board of trustees or similar body with a fiduciary duty to the plan. The federal legislation would require that the plan members (both unionized and non-unionized), retirees and other beneficiaries be represented and have voting rights on the board. Plan sponsors could be represented on the Board, although this would not be an obligation. The level of representation of each party would be negotiated. The board of trustees could also include external representatives, such as pension experts, professionals or representatives of another union, which may be voting members or observers.

Decision-making rules would need to ensure that none of the parties has a disproportionate power or influence within the Board. A person would not be allowed to be appointed as administrator if they were to find themselves in a conflict of interest between their responsibilities as a trustee and their other responsibilities.

The Superintendent of Financial Institutions would have the power to remove an unfit administrator as is currently the case under the PBSA. All PBSA requirements applicable to the "administrator" would apply to the board of trustees as a whole.

ROLE OF THE BOARD OF TRUSTEES

As it is currently the case under the PBSA, the role of the Board of Trustees for federally-regulated TBPs would be to administer the plan and make decisions in accordance with the relevant plan documents (plan text, benefits policy, funding policy, including deficit recovery and surplus utilization investment policy, etc.). The Board would not have the power to amend these documents, which would remain the prerogative of the employer, members and retirees. The Board could, however, recommend that amendments to plan documents be submitted for approval to the plan's parties when appropriate. Employers would not be allowed to unilaterally amend the plan provisions. The Board would also be responsible for communications with members and the filing of required documents with the Superintendent of Financial Institutions.

The Board of Trustees would be required to act solely in the best interest of plan members. The Trustees would be allowed to delegate some of their functions to a third party, including to the plan sponsor (e.g. the calculation of benefits, communications with members and beneficiaries, disclosures, certain investment decisions, etc.).

PROTECTION FROM LIABILITY

The existing provisions under the PBSA protecting the administrator of a pension plan or any of their employees or agents from liability would apply in the context of a federally-regulated TBP as well. Under these provisions, a plan administrator is released from statutory liability where they contravene the standard of care, standard for investing assets, and skill and knowledge requirements by relying in good faith on specified categories of documents prepared by certain professionals.

QUESTIONS

1. **Is this governance framework appropriate for federally-regulated private sector and Crown corporation pension plans wishing to convert to a target benefit plan?**

   We believe that this framework is appropriate for both federally-regulated private sector and Crown corporation pension plans that are considering conversion to a TBP.

2. **Should the federal legislation or regulations be prescriptive regarding the composition of the governance body (e.g., proportion of plan members and retirees, presence of independent trustees)?**

   We believe that the legislation / regulations should not be prescriptive beyond the comments made above under the subheading "Nature and Composition of the administrative body". Best practices will evolve over time and more regulation, if needed, can be introduced at a later date when both the regulator and the various stakeholders have had more experience with TBPs. We strongly recommend that the employer should be represented on the Board, if the employer so chooses, rather than leaving this as a decision to be made by the Board. If a plan is mismanaged, it is the employer who will bear at least some of the consequences of the ensuing disruption. We also question allowing outside experts or professionals to be represented on the Board if such person, or the person's firm, provides services to the plan and receives remuneration as a result.

3. **Should the Board of Trustees have powers to amend plan documents?**

   The Board should have the power to amend documents that do not change benefits or contributions in a material fashion. Examples of amendments that Boards should be allowed to make include those that clarify intent or administrative practice, and update plan rules to reflect legislative changes (the increase under the *Income Tax Act* of the maximum retirement age from 69 to 71, for example).

4. **What should be the plan member support level requirement for making substantial amendments to the plan text?**

   We assume in this context that "plan text" also includes the funding policy document. In the TBP framework, the funding policy will set contribution limits (presumably deemed by the sponsor as "affordable") for the contributing parties so, when movement within the permissible range is triggered, amendments should not be required with respect to contributions. The funding policy will also set forth how benefits are to be improved with funding surpluses, as well as how funding deficits are to be addressed.

That said, should substantial amendments be desired by any stakeholder group, the stakeholder group(s) who created the TBP should retain the right to amend it. If member support was required to create the TBP, for example, then member support should be required to make substantial amendments. This begs the question of what constitutes member support. If we seek a precedent, we would note that surplus-sharing rules require the written consent of two-thirds of each member class. This would be a good starting point.

However, referring back to question 3 from this section, we believe that the Board of Trustees should retain the ability to make amendments that are more maintenance-driven. We believe that this is more efficient than, potentially, trying to go back to the parties for every plan amendment.

Regardless of what amendments are being made and by whom, we believe that whatever prescribed risk management goals and tests may exist in the TBP framework need to be met / passed in order for amendments to be approved.

5. **Should there be different governance framework provisions applicable to federally-regulated pension plans in unionized and non-unionized environments?**

   As a general statement, the governance framework should be consistent in both unionized and non-unionized environments. However, in unionized environments, the bargaining agent for the union should be able to represent its members as a homogeneous group, both on the Board of Trustees and in any decisions requiring member approval. In a non-unionized environment, individual members may have the right to “vote” with respect to items requiring member approval.

   The proposed framework would require a joint governance structure with a Board of Trustees or similar body in all cases. While this is appropriate in unionized environments, it may not always be practical in non-unionized single-employer environments where no bargaining agent(s) represents the bulk of plan members. In these cases, we suggest consideration be given to not requiring joint governance, but rather introducing other mechanisms to ensure interests of plan members are protected in the operation of the TBP. This will also have the benefit of making TBPs a viable alternative for non-unionized single employers that do not want to adopt joint governance approach. We note DC plans carry far more risk for plan members than TBPs but do not require joint governance.

6. **What type of process could be used for negotiating provisions of the plan with employees in federally-regulated non-unionized environments?**

We would suggest that the existing rules for negotiating surplus sharing arrangements with plan members could be used to provide guidance for establishing a method of securing agreement with employees in a federally-regulated non-unionized environment. The situational dynamics are fundamentally similar (significant change in plan funding and structure) and we would suggest that an analogous process would be appropriate.

FUNDING POLICY

Under TBPs, benefit levels are “targeted” rather than “defined” or “guaranteed.” In general, employer contributions and employer liability are capped or are limited to contractually required contributions. Therefore, members and retirees bear the cost of any funding shortfalls in the form of increased contributions or reduced pension benefits, but would also be entitled to any funding surpluses that may arise.

CONSIDERATIONS

FUNDING FOR DB PLANS

Currently, all DB pension plans under the PBSA are subject to both solvency and going-concern funding rules. The solvency funding ratio provides an important measure of the financial health of the plan by indicating the plan’s capacity to meet its obligations in the event of immediate termination. Solvency funding rules require that the assets of the plan be sufficient to meet the expected cost of the promised benefits as calculated under an actuarial valuation report, based on the assumption that the plan is terminating at the time of the valuation, requiring the conversion of a periodic benefit into a lump sum. In contrast, going concern funding rules are based on the assumption that the plan is continuing but not accruing new benefits or accepting new members.

BENEFIT PROTECTION

It is important to ensure that the federal TBP funding model continues to provide benefit protection to plan members and retirees while achieving stability of contributions and benefits. The funding rules should be designed to enforce a level of discipline on plan administrators to ensure that there is a high probability of delivering the target benefits.

UNIQUE FEATURES OF TBP PLANS

DB plans provide limited flexibility to adjust plan provisions to cope with funding shortfalls. Consequently, plan sponsors are solely responsible for funding deficits, which, if they are not capable of absorbing the costs, can lead to the termination of the plan. The federal TBP framework should provide flexibility to adjust contributions and benefits following changes in the plan’s financial situation. As outlined in the proposals presented below, federally-regulated TBPs would be required on an ongoing basis to make the adjustments to the plan parameters necessary to maintain the viability of the plan. The adjustments would need to be made on a timely basis before the plan’s funding status deteriorates to a point where it becomes unsustainable. Such mechanisms reduce the likelihood of insolvency leading to plan termination. In addition, in the event of plan termination, whether due to insolvency or other reasons, the lump sum to be paid to plan members is not a guaranteed promise, but would depend on the financial situation of the plan at that time. Consequently, solvency funding requirements, which are based on termination scenarios, do not appear necessary in the federally-regulated TBP context. Federal TBP funding rules would focus on the ongoing functioning of the plan.

FUNDING MARGIN

While solvency funding requirements may not be needed, a funding requirement strictly based on the existing going concern ratio may not be sufficient to ensure that target benefits will be paid with a reasonable likelihood. It would therefore be appropriate to incorporate a margin or buffer into the going concern ratio calculation which could respond in a counter-cyclical manner to plan experiences by being built up during strong economic periods (i.e., favorable plan experiences) and drawn upon during poor economic periods (i.e., adverse plan experiences). The buffer can be designed in a manner to reflect the investment approach by basing the buffer level on the asset allocation of the pension fund (i.e., the margin would be higher if the fund holds riskier investments).

In a research paper[1] published in January 2013, the Canadian Institute of Actuaries (CIA) provides guidance for actuaries in calculating a Provision for Adverse Deviation (PfAD) in going concern plan valuations. The PfAD represents additional funding required to build a buffer margin allowing the plan to remain adequately funded despite potential unpredicted future changes in economic or other factors. In the CIA paper, PfADs were calculated for 75 percent and 90 percent probabilities that the plan would remain fully funded on a going-concern basis at the first triennial valuation date (i.e., three year time horizon). The calculated PfADs also vary based on equity vs. bond allocation as well as plan maturity (as measured by the percentage of liabilities that are attributable to retirees currently receiving benefits vs. liabilities attributable to the future benefit of active members).

PROBABILISTIC VS. MARGIN APPROACH

An alternative to an explicit requirement for a margin would be to adopt an approach which requires a primary risk management goal that provides a specific probability that the “base benefits” will not be reduced over a specified period of time and a secondary risk management goal requiring a specified percentage of “ancillary benefits” be delivered over this same period (e.g., 97.5% and 75% respectively over a 15 year period). The categorization between base and ancillary benefits is discussed in section 4.4 Benefit Structure. This “probabilistic” approach could provide plans with a certain degree of flexibility on how the plan is funded, as long as they meet the “probability test”. Such an approach would however be more complex from a plan administration standpoint as it is dependent on individual actuarial judgment. Further, there are currently no professional actuarial standards for the probability test.

TIME HORIZON

The existing going concern funding requirements under the PBSA are based on a best estimate of the present value, at the time of valuation, of expected future cash flows. This provides a fairly limited view of the future as it only reflects accrued benefits at the time of the valuation and does not include the impact of the entry of new members in the plan (i.e., it is calculated on a “closed group” basis). An alternative approach is the going concern ratio calculation on an “open group” basis. This approach requires a future projection of the plan’s going concern ratio (e.g., 15 years out), incorporating estimates of benefit accruals, contributions and new plan members joining in the future. This approach allows, among other things, for the impact of changes in contribution rates to be taken into account in the valuation, which the current going concern valuation under the PBSA does not provide for.

PROPOSED APPROACH

It is proposed to introduce a general requirement for the plan administrator to establish a funding policy for the federally-regulated TBP, which must be submitted to the Superintendent of Financial Institutions.

In place of solvency funding requirements, in order to reduce the likelihood of funding shortfalls, a funding test based on a going concern valuation is proposed. There are two fairly different approaches that have been adopted or proposed in Canada so far in relation to TBP funding and there are different views among pension experts and stakeholders as to which one is preferable. The legislative and regulatory framework would be based on one of the following two funding test approaches:

- A going-concern funding requirement with a PfAD. The funding ratio would be calculated as follows: Assets / Going Concern liabilities +PfAD; or
- A going concern funding requirement and:
- A primary risk management goal that provides a specific probability (e.g., 90%) that the “base benefits” will not be reduced; and
- a secondary risk management goal that provides a % probability (e.g., 75%) of delivery of the “ancillary benefits”

Under the first approach, the level of the PfAD applicable to each specific plan would be based on simple metrics for that particular plan, i.e., on the asset allocation of the pension fund and the degree of plan maturity. For example, in the CIA paper, the required PfAD would be 8% of liabilities for a plan with an asset mix of 60% in equities and 40% in bonds and where the proportion of liabilities attributable to pensioners and active members are 50% respectively.

Periodic valuations for disclosure purposes to plan members and the Superintendent would include the results of stress testing.

While there would be no requirement to fund the plan on a solvency basis, TBPs should still provide solvency valuations for disclosure purposes to the supervisory authority as well as plan members and retirees.

QUESTIONS

1. **Is the going concern valuation sufficient to measure and fund target benefits?**

   One of the main reasons for solvency funding requirements within DB plans is the fundamental difference between benefits provided on an ongoing basis and those provided in the event of plan termination. Aligning these benefits should remove the need for funding on a solvency basis. This was true in the case of New Brunswick Shared Risk plans (SRPs) and is equally true with TBPs.

   A going concern valuation should therefore be sufficient.

2. **Which approach should be adopted under the federal legislative and regulatory framework: the margin or the probability test?**

   For years, insurance companies have provided “guaranteed” financial products to Canadians and, as a result, have been subject to very strict risk management practices and procedures.

Unfortunately, many DB pensions in Canada have not implemented comparable approaches (notwithstanding the fact that most plan stakeholders have believed that plan benefits were "guaranteed"). We believe that the movement toward TBP designs should be accompanied by a more robust risk management framework for Canadian pension plans.

To that end, we believe that the probability test framework provides better information to plan stakeholders regarding the risks inherent in their TBP. By putting benefits potentially at risk, care must be given to creating a legislative and governance framework that both mitigates these risks and effectively communicates them to plan members.

However, we understand that some stakeholders may have concerns with excessive operating costs associated with the probabilistic risk management approach, particularly for small plans looking to convert. A compromise could be reached by requiring probability tests at less frequent intervals than margin-based tests. Alternatively, perhaps certain funding thresholds could trigger a move from a probability test to a margin test. Better funded plans may be better able to get by with a margin test, while less well funded plans may require a probabilistic test. In addition, smaller plans – with going-concern assets below a prescribed threshold – might be permitted to use only a margin test.

Regardless of the approach taken, consideration needs to be given to maintaining reasonable intergenerational equity. In the past, being too aggressive has meant that costs often were shifted to future generations. Excessive conservatism will result in today's generation getting less than what might realistically prove to be affordable. It is critically important to establish a reasonable balance between the interests of the various generations of participants.

3. **Is the PfAD approach appropriate as a funding margin or should a different margin calculation be provided for or allowed (e.g., through a discount rate margin)?**

Keeping the foregoing comments in mind, we believe that the PfAD approach is more appropriate and robust than a simple discount rate margin. If legislation is under consideration that would allow benefit reductions, the sophisticated tools that exist to measure and manage those risks should be considered as best practice.

4. **What is the appropriate time horizon for the purposes of calculating the PfAD?**

Our recommendation is that 20 years (at minimum) would be an appropriate time horizon.

5. **Should going concern valuations be required on a closed group or open group basis?**

We believe that stakeholders would agree that managing a very mature DB plan requires very different approaches to funding, benefit and investment decisions than those for a very young DB plan. For two plans with the same assets and liabilities but with vastly different demographics, different actions would be recommended.

Accordingly, we recommend an open group approach to measuring and managing funding, benefits and investments. For clarity, we define "open group" in the same manner as New Brunswick has in its

SRP legislation. This includes the present value of contribution margin (i.e., the excess of contributions over base benefit costs) for the next 15 years in current assets. If TBPs truly are a long-term solution that is going to be sustainable under many scenarios, it is important to consider expected future changes in demographics over the medium term when making decisions in the short term.

6. How frequently should valuations be required?

Valuations should be required annually below a certain funding threshold, and perhaps triennially for well-funded plans. Consideration should be given to legislation that triggers actuarial valuations more frequently than every three years in certain conditions (i.e., a negative fund return in a given year produces a projected funded position below the threshold, material changes in plan membership due to layoffs, etc.).

7. Should some of the specifics on the funding policy (e.g., PfAD rates) rely on guidance from sources such as the Canadian Institute of Actuaries (CIA) or should they be more fully prescribed in legislation or regulations?

We agree that professional guidance is an invaluable source of support. If an outcome-focused approach is taken (the probability test), then the CIA may guide actuaries in the process, but this need not be a legislated provision. If the PfAD approach is taken, we would propose that this be established in regulations to balance regulatory authority with the ability to react to emerging professional guidance.

CONTRIBUTIONS

In the TBP environment, contributions may act as a key instrument in facilitating risk sharing. Depending on the specific model chosen, contributions for both the employer and employee may rise or fall as necessary to ensure the target benefit is being met, or deal with surplus situations. However, as noted under section 4.2 Funding Policy, employer contributions may be capped or fully limited to contractually required contributions, as set out during collective bargaining or during an equivalent process for non-unionized environments.

Section 4.11 Plan Termination and Wind-up proposes that solvency funding requirements be maintained for 5 years following conversion (see section 4.8 Conversion of Pension Plans to Target Benefit Plans) to ensure federally-regulated pension plans do not convert from a DB plan to a TBP to avoid PBSA termination and wind-up rules for DB plans. If this proposed rule is applied, the contribution rules would need to accommodate temporary solvency funding contributions from the employer during this first 5 years following conversion. Section 4.11 includes a question seeking views on this rule.

PROPOSED APPROACH

The proposed contribution model would require contributions in excess of those needed to cover normal costs of the plan. As discussed in section, 4.2 Funding Policy, these excess contributions would allow for a margin to be established which would provide the plan with the ability to withstand shocks. Depending on the funding model chosen, this margin would be established either in the form of a PfAD or by requiring a minimum funded ratio threshold to be maintained and a risk management goal to be met. A minimum standard would be established under federal legislation/regulations as outlined in section 4.2.

The federal legislation would allow for increases and decreases in employee contributions. The proposed federal framework would also allow for either fixed or variable employer contributions. The specific model would be established in the plan text through negotiation.

If an employer-fixed contribution model is chosen, employee contribution increases may still occur, however this must be clearly outlined in the plan text. If employee contribution increases are included, these increases would act as the first step in adjusting for funding shortfalls. A cap on the variability level of employee contributions would need to be established.

Alternatively, the plan may also choose to include variable employer contributions. The variability in the contribution level would be determined during the collective bargaining process and employee and employer contribution variability would not necessarily need to be equal. A cap on the chosen variability level for both employer and employee must be provided. An increase in contributions would occur according to the deficit recovery and surplus utilization plans and triggers would be reflective of the funding model chosen, as outlined below. Decreases in contributions could only occur if the buffer margin is fully funded or, under the probability test approach, both the funded ratio threshold and the probability test are met.

Triggers for contribution increases would depend on the funding model chosen. If the margin approach is adopted, contribution increases would need to occur once the entire buffer margin is depleted. Increases should, however, occur before reaching that point in order to maintain the buffer and avoid benefit reductions. Under a “probability test” funding requirement, contribution increases would be required as soon as either the going concern ratio falls below 100% or the probability test is not met. The details of these actions would be determined in the deficit recovery plan. Benefit reductions would follow if the plan's funding levels remain unable to meet the target benefit.

Temporary solvency contributions by the employer would be required to facilitate the conversion requirements which ensure solvency funding is maintained for a certain number of years following conversion of a federally-regulated DB plan to a TBP.

As indicated above, flexibility would be provided for details of the contribution model to be determined at the plan text level. However, the following details must be provided in the plan text:

- Whether the plan operates on a employer-fixed or variable contribution schedule;
- A schedule of employer and employee contribution rates, expressed as a percentage of payroll or as a dollar amount;
- The range within which contribution rates could be adjusted, if a variable contribution schedule is chosen; and,
- Triggers for adjusting contribution rates, as determined during negotiations with employees (i.e., what would trigger an increase or decrease in contributions, how these triggers would operate).

QUESTIONS

1. **Is this approach to contributions for federally-regulated plan appropriate?**

   We believe that this is an appropriate approach to contributions.

2. **Should some of the specifics concerning contributions be determined by plan members or more fully prescribed in legislation or regulations?**

   In our experience with similar designs in New Brunswick, it is really the contribution level and benefit security goals that drive the benefit levels set forth in the design. This is contrary to traditional DB plans, where the benefits drive the contribution requirements both in terms of magnitude and volatility. We see TBPs as more contribution-focused: answering the question of how much does each party (sponsor / members) want to pay into the pension fund is the most appropriate first step. After answering that question, the second issue is what range around that target is each party comfortable with (subject to legislated maximums and minimums). Particularly for plan sponsors, it is the magnitude and volatility of their contributions that is driving the shift away from DB plans towards DC and, potentially, TBP designs.

   Once the contribution questions are answered, the base and ancillary benefits that can be provided under the plan are driven by the risk management goals (for example, 97.5% security for base benefits and 75% expected value of ancillary benefits). We caution that, while setting the goals at a very high level will improve the security of benefits for the current generation of members, it will also depress the level of benefits that can be provided to those same members and may well exacerbate the problem of inter-generational equity.

BENEFIT STRUCTURE

Under TBPs, benefits are targeted rather than defined or guaranteed. In addition, when the sponsor and employees share risks (which could include adjustments to both contributions and benefits, the latter which affect employees only), the parties to a pension contract may prefer benefit protections to apply differently for certain types of benefits or classes of members or beneficiaries in order to balance the objectives of pension security and plan sustainability.

CONSIDERATIONS

ADAPTS TO MARKET CONDITIONS

TBPs are generally able to adapt to market conditions because of the ability to adjust benefits in certain circumstances. Plan administrators could be provided with the flexibility to identify if any benefits are fully guaranteed, such as accrued benefits. Permitting the full protection of certain benefits recognizes that in some circumstances, a minimum level of benefit guarantee may be preferred by all plan parties. However, the greater the unconditional guarantee on benefits, the less flexibility plans have to adapt to market conditions and the more an employer would be exposed to funding risk.

SECURITY OF BENEFITS

The federal TBP framework could allow for all benefits to be treated with the same level of member protection regardless of the type of benefit, or they could be divided into classes of benefits to permit plans to offer varying levels of benefit protection depending on the benefit type. Establishing classes of benefits leads to a transparent prioritization of benefit reductions/increases when the plan is faced with a deficit/surplus, for example, a two-tier benefit structure where benefits are divided into "base benefits" and "ancillary benefits." Base benefits include a lifetime pension at normal retirement age, past indexation, and vested ancillary benefits. The ancillary benefits include future indexing and early retirement benefits such as bridge benefits.

CATEGORIZATION OF BENEFITS

An adequate benefit security would require that the largest portion of benefits, in monetary value, be categorized as base benefits and be subject to increased protection. Hence, the base benefit should normally include, at a minimum, the pension benefit payable at normal retirement age and corresponding to a percentage of salary (whether career or final average or any other formula) per admissible years of service. Other components of the overall pension benefit, such as death or disability benefits, early retirement or bridging benefits, spousal benefits or indexing could be categorized as either base or ancillary benefits, depending on the plan's financial situation, demographics, and the plan parties' risk tolerance.

The federal legislative TBP framework could identify the specific benefits within each class of benefits, or the plan parties may be provided with the flexibility to determine what benefits are included in each class of benefits. Specifying what benefits are in each class would provide clarity and certainty to all parties as to what benefits are priorities and which are not; however, it may be the case that the classifications are not appropriate for all plans.

PROPOSED APPROACH

The proposed federal TBP framework would provide for two classes of benefits with a varying level of benefit protection:

- Base benefits could be reduced but would have a high level of protection and would only be reduced as a last resort.
- Ancillary benefits would have a lower level of protection and would be reduced before base benefits were reduced.

The proposed federal TBP framework would provide flexibility for the plan text to specify which benefits would be categorized in each of the base and ancillary categories, which benefits could be reduced or increased, and in which order of priority. The reduction of accrued benefits under these provisions would be allowed, but not required, if provided for in the plan text. Converting a base benefit into an ancillary benefit or vice-versa, and thereby altering the overall level of protection would be possible, but would require amendments to the plan text with the associated member consent and filing process.

QUESTIONS

1. **Is the approach of categorizing benefit in two classes appropriate?**

   Yes, we believe the categorizing of benefits into two classes with different levels of security is appropriate.

2. **Should base and ancillary benefits be determined by pension plans or more fully prescribed in federal legislation or regulations?**

   Pension plans should have the discretion to set their own delineation between base and ancillary benefits. The legislation should, however, clearly set out the funding and security requirements of each class. In doing so, we caution, as we have elsewhere in this submission, against setting the security requirements too high. The legislation should also include minimum standards for what must be classified as a base benefit in the conversion of accrued DB benefits to a TBP. While negotiated conversions in collectively bargained situations should be allowed additional flexibility, we would propose that the nominal dollar value of benefits currently payable and the terms of attained eligibility (i.e., age and / or “points” rules) be classified as base benefits.

FUNDING DEFICIT RECOVERY PLAN

Pension standards legislation across Canada generally defines a deficit as the excess value of plan liabilities over the assets of the plan. Matters related to the liability for funding deficits, payment schedules and approval processes, are typically included in legislative provisions. Unlike traditional DB plans, where the plan sponsor is solely responsible for funding the deficit, the shared-risk nature of TBPs implies that plan members and beneficiaries would also have a responsibility to fund deficits. The level of flexibility in determining contributions and benefits will determine the specific deficit recovery measures that must be taken as well as their prioritization.

CONSIDERATIONS

CHANGE IN THE PLAN'S FINANCIAL POSITION

Volatility in the markets may cause rapid changes in the funding position of a pension plan. Accordingly, if a pension plan finds itself in a deficit position, steps should be taken early on to prevent the deficit from challenging the sustainability of the plan. The federal legislative framework should therefore be clear on the desired outcome of deficit funding measures and the need for timely action.

CONSISTENCY WITH THE FUNDING REQUIREMENT, BENEFITS AND CONTRIBUTIONS MODEL

Deficit recovery provisions should be consistent with the funding requirement, which sets the level of the plan's financial health that must be reached. Hence, the trigger for implementing deficit reduction measures, and the threshold for determining when such measures are no longer needed, depending on the funding approach, would be based on either:

- the going concern funding ratio including the PfAD; or
- the going concern funding ratio and the "probability test".

The range and prioritization of deficit recovery measures would also be linked to the extent of variability in employee and employer contributions. In a model where variations in contributions act to reduce the risk of benefit reductions, contribution increases would be the first and possibly the main deficit recovery measure. In contrast, if employer contributions are fixed, the scope for increasing total contributions is more limited and, once the cap on employee contribution increases is reached, benefit reductions would more likely be needed to meet minimum funding requirements.

Finally, the prioritization of deficit recovery measures should reflect the level of protection granted to the different categories of benefits. Accordingly, in a deficit situation, benefits categorized as "ancillary" should be reduced in priority to benefits categorized as "base".

IMPACT ON PARTIES

In prioritizing deficit recovery actions, plan administrators should take into account that some actions will have varying impacts on the different parties. For example, increases in contributions will only impact active members, while reductions in benefits are more likely to impact retirees right away with a deferred impact on active members.

PROPOSED APPROACH

DEFICIT RECOVERY PLAN

The proposed federal approach is a requirement that detailed rules and provisions regarding deficit recovery be set in a deficit recovery plan that could be a standalone document or part of the plan text. The plan, which would have to be filed with the Superintendent, would have to contain the following elements:

- Trigger for deficit recovery measures;
- Timelines for implementing the measures;
- Description of all measures and order of priority;
- Minimum funding level to be reached through the measures; and
- Approval process.

LIABILITY

Under federally-regulated TBPs, depending on the deficit recovery measures set out in the plan text and how they are prioritized, responsibility for funding deficits could be shared between some or all of the plan parties, i.e., the employer, plan members, retirees and other beneficiaries.

TRIGGER

If the margin approach is adopted, deficit recovery measures would, at a minimum, need to be triggered as soon as the margin or PfAD is completely depleted (i.e., when there are no more assets to cover the value of the PfAD). Measures would need to continue to apply until the funding ratio reaches 100%, (i.e., the PfAD is fully built-up again). Plans should, however, implement a deficit recovery plan before full depletion of the PfAD so as to maintain the buffer and avoid benefit reductions.

Under a “probability test” funding requirement, deficit recovery measures would be required as soon as either:

- the going concern ratio falls below 100%; or
- the probability test is not met.

TIMELINE

The deficit recovery plan would have to set out the maximum time period (e.g., one year) to implement deficit recovery measures.

DEFICIT RECOVERY MEASURES

There would be a requirement that the measures to be taken in relation to a funding deficit and the order or priority be clearly set out in the deficit recovery policy. The policy would have to specify what actions are required while the plan is ongoing and their prioritization, and what actions would apply in case of plan termination.

Such actions could include:

- increase in plan member or employer contributions (if allowed);
- special payments by the employer;
- reversing past increases in benefits;
- reductions of past and future ancillary benefits; or
- reductions of past and future base benefits; (including corresponding reductions in commuted values for members ending their participation in the plan, or in the case of plan termination).

PROCESS

Once the deficit recovery measures are triggered, the Board of Trustees would have the authority and obligation to implement the specified measures, without requiring the consent of plan members and retirees.

QUESTIONS

1. **Should the deficit recovery measures and their prioritization be determined by plan members or more fully prescribed in federal legislation or regulations? If the latter, what measures should be prescribed and what should be their order of priority?**

   Deficit recovery measures should be prioritized by plan stakeholders. However, the legislation should make it clear that base benefits would be reduced only as a last resort. Legislation should also consider limits on other measures. For example, in New Brunswick, future benefits cannot be reduced by more than 5% in the funding deficit recovery plan before consideration is given to reducing past base benefits. This measure is intended to limit the potential degree of intergenerational inequity.

2. **Should deficit recovery measures be triggered as soon as the PfAD starts to be depleted or the probability test is not met?**

   Consideration should be given to legislation that does not create unnecessary volatility in either contributions or benefit levels. There is a risk that requiring an immediate response to either of these triggers will create undue volatility for the TBP. New Brunswick took the approach of requiring two successive years of “test failure” before requiring action. We would suggest that this be combined with a minimum failure level (i.e., if, after all other deficit recovery steps are taken, a benefit reduction of <5% is required to achieve a fully funded level, then benefits would not be reduced until a third consecutive year of <100% funded occurred). We recognize that this approach is shifting some of the risk to a future generation of members and / or is increasing the potential magnitude of the reduction in benefits that is eventually required, but this danger is considered to be the lesser of two evils during a time when the plan is experiencing a funding challenge.

FUNDING SURPLUS UTILIZATION PLAN

Surplus is defined in federal and provincial pension legislation as the excess value of plan assets over the liabilities of the plan. Matters related to surplus distribution, including issues such as entitlements, rules for withdrawal and approval processes, are typically included in legislative provisions. The shifting of risks towards plan members and retirees under a TBP means they would be entitled, at least in part, to a funding surplus. Exactly how a surplus is distributed will depend on rules and provisions relating to the setting and changes in contributions and benefits.

CONSIDERATIONS

CHANGE IN THE PLAN'S FINANCIAL POSITION

Volatility in the markets may cause rapid changes in the funded position of a pension plan. Accordingly, if a pension plan has a surplus, care will have to be taken to ensure that it is not spent or distributed too quickly, which could bring the plan into a deficit position. A minimum threshold for allowing access to the surplus could be applied, for example a minimum margin above the fully-funded ratio of 5%, in addition to meeting the probability test.

CONSISTENCY WITH THE FUNDING POLICY, BENEFITS AND CONTRIBUTIONS MODEL

Surplus utilization provisions should be consistent with the funding policy. The rules for allowing surplus utilization and related limits should ensure that, at a minimum, no plan assets should be distributed or used as surplus until the value of plan assets fully covers the going concern liabilities and either the PfAD is funded or the probability test is met, depending on which approach to funding is taken.

The range and prioritization of surplus utilization measures should also be tied to the extent of variability in employee and employer contributions. In a model where substantial variations in contributions serve to reduce the risk of benefit reductions, contribution reductions could be the first and possibly the main surplus utilization measure. In contrast, where contributions are fixed or subject to a narrow variation range, a surplus would be mainly allocated towards benefit increases.

Finally, the prioritization of surplus utilization measures should reflect the level of protection granted to the different categories of benefits. Accordingly, in a surplus situation, the reversal of prior reductions in benefits should prioritize benefits categorized as "base" before benefits categorized as "ancillary".

ENTITLEMENT

Given that, under a TBP, the risk is shifted towards the plan members and beneficiaries, so too should the rewards associated with risk-taking. Accordingly, it is reasonable that surplus allocation measures include an equitable allocation to members and beneficiaries. Provisions relating to entitlement to the surplus should be clearly articulated in the plan text.

SURPLUS AVAILABLE FOR USE

Once a threshold or trigger is set for utilization of a surplus, it must be determined how much of this surplus can be used, and under what timeframe. In order to ensure the plan does not end up in a deficit position, it may be desirable to set limits on how much of the surplus can be used (and consequently how much of it should remain in the fund) and/or require that actions such as changes in benefits or contributions be gradually phased in over a few years to prevent a rapid change in the plan's funding position.

IMPACT ON PARTIES AND EQUITY

In prioritizing the surplus utilization actions, it must be taken into account that some actions will have varying impacts on the different parties. For example, reductions in contributions would only benefit active members and the plan sponsor, while increases in benefits would provide retirees with an immediate advantage.

LEVEL OF PRESCRIPTION

In order to avoid uncertainties and disagreements between parties, the rules for the allocation and use of a funding surplus should be clearly set out ex ante. This could be achieved through legislation and regulations or in a detailed manner in the plan text or one of the plan's policies further to a legislative or regulatory obligation to do so.

ONGOING VS. TERMINATED PLANS

The surplus utilization rules and policies should distinguish between plan terminations (where all the assets of the plan are distributed and no further liabilities are incurred), and ongoing plans (where a funding surplus exists only notionally in a plan that has continuing liabilities) in order to reflect their different circumstances.

PROPOSED APPROACH

SURPLUS UTILIZATION PLAN

It is proposed to establish a requirement that detailed rules and provisions regarding surplus utilization for federally-regulated TBPs be set out in a surplus utilization plan that could be a standalone document or part of the plan text. The plan, which would be filed with the Superintendent, would be required to contain the following elements:

- A trigger for surplus utilization measures;
- A cap on surplus utilization;
- A description of all measures and order of priority; and
- An approval process.

ENTITLEMENT

The federal legislation would not impose the sharing of the surplus between the employer and plan members and beneficiaries, nor would it state that only members and beneficiaries should be entitled to the surplus.

Which parties benefit from the surplus would ultimately depend on what the surplus allocation measures are and how they are prioritized. Provisions relating to entitlement to the surplus should be clearly articulated in the plan text.

SURPLUS UTILIZATION TRIGGER

The federal legislation would require that a threshold be set in the surplus utilization policy for access to the surplus. This threshold would need to be set at 100% of the going concern ratio, including the PfAD, plus a supplemental margin (e.g., 5%). Under the "probability test" funding approach, both the ratio threshold and the probability test would need to be met for access to the surplus. This threshold would be a minimum, and there would not be an obligation to use the surplus as soon as the threshold is reached. The policy would also have to specify the timing for surplus access, e.g., establish whether the above tests be met for two or more consecutive valuations before actions can be taken in relation to a surplus.

CALCULATION OF SURPLUS AVAILABLE FOR USE

The surplus utilization plan would specify how much of this surplus can be used, and under what timeframe. The cap as a dollar value or percentage would be set out in the policy, as well as any phasing-in period for surplus utilization actions.

SURPLUS UTILIZATION ACTIONS

The federal legislation and regulations would require that the actions that can be taken in relation to a funding surplus and the order or priority be clearly set out in the surplus utilization policy. The policy would specify what actions are allowed while the plan is ongoing, and what actions would apply in the case of plan termination.

Such actions could include:

- reverse reductions of past and future base benefits;
- reverse reductions of past and future ancillary benefits;
- temporarily improve ancillary benefits (indexing, early retirement benefits, survivor benefit, etc.);
- improve base or ancillary benefits;
- reduce plan member contributions;
- reduce employer contributions;
- refund to the employees or employer; and
- payout to plan members and beneficiaries (on termination).

QUESTIONS

1. **Should the surplus utilization measures and their prioritization be determined by plan members or more fully prescribed in legislation or regulations? If the latter, what measures should be prescribed and what should their order of priority be?**

   Surplus utilization measures and their prioritization should be determined by the plan stakeholders. As proposed, legislation should require a minimum threshold before surplus can be utilized (the consultation paper proposes 5%) and temper the amount of surplus that can be spent in a given year (in New Brunswick, 1/5 of the surplus between 105% and 140% can be spent annually, and all of the surplus above 140%) in order to minimize the chance of benefit reductions in the TBP.

   With respect to priority order, "undoing" any prior benefit reductions should be the first priority for utilizing any eligible surplus. More generally, but perhaps not prescribed in the legislation, surplus utilization could follow the deficit recovery plan in reverse order.

2. **What would be an appropriate margin (over the fully-funded level) to allow surplus utilization? What would be an appropriate cap on the utilization of surplus?**

   We note that for SRPs in NB, a 5% margin was deemed to be appropriate. Additionally, SRP legislation limited surplus utilization to 20% of the available surplus between 5% and 40%. While some similar level of prescription may be reasonable for plan sponsors that unilaterally convert their plans to TBP, we would favour a less prescriptive approach for negotiated TBPs that are subject to member consent.

   As a clarification, we would propose that the measurement of TBPs' funded level differ when analyzing routine ancillary benefit increases (i.e., indexing) versus ongoing changes such as contribution reductions. The measurement of funded position when ancillary benefits are provided should be on the "open group" approach and include the value of future contribution margin in the value of plan assets. However, trigger points for contribution reductions should be measured on a closed group basis and exclude the value of future contribution margins from the value of plan assets.

DISCLOSURE AND COMMUNICATIONS

Existing disclosure rules under the Pension Benefits Standards Act, 1985 (PBSA) and the Pension Benefits Standards Regulations, 1985 (PBSR), require the plan administrator to provide significant information to plan members upon enrolment, termination, and retirement.

CONSIDERATIONS

The objective of the disclosure rules is to ensure the members and retirees are aware of the status of their plan and any amendments that may occur.

PROPOSED APPROACH

It is proposed that the federal TBP disclosure provisions include requirements for the plan administrator to provide information to members and retirees prior to conversion from a federally-regulated DB plan, during membership, in the event of membership termination or death, and in the event of plan termination and wind-up. Disclosure requirements would also be in place for new members upon enrolment.

The disclosure rules would seek to follow the existing rules outlined in the PBSA and PBSR as much as possible. Additional disclosure requirements for federally-regulated TBPs would include:

- A comprehensive explanation of the plan's funding policy and benefits rules (e.g., benefits structure; structure of contributions; risk management goals and procedures; funding surplus and deficit recovery rules);
- Notification from the Board to the plan sponsor of any changes as a result of the implementation of the deficit recovery plan or surplus utilization plan (e.g. contribution increases);
- Written "pre-notice" to members and retirees indicating any upcoming changes (increases or decreases) in contributions (applies to members only) or enhancements or reductions in benefits in accordance with the plan's funding policy 180 days prior to these changes taking effect;
- Details in the annual statements on the expected base and ancillary benefits if the plan continued to perform under existing conditions and accumulated termination value that would be awarded if the plan were terminated immediately; and
- Plan sponsors would be requested to provide the address of the Financial Consumer Agency of Canada web page in advance of converting to a federally-regulated TBP so that plan members and beneficiaries better understand the risks and benefits of these plans.
- Disclosure rules would also outline filing requirements with the supervisor. As with members and retirees, the provisions would seek to follow the PBSA and PBSR as closely as possible. Additional filing requirements would include:
    - Details of the funding policy for the plan; governance policy; investment policy; risk management goals and procedures for the plan; and details of communication material that they plan to provide to members and retirees regarding the risk sharing characteristics of the federally-regulated TBP upon conversion or inception.
    - Updates on the above listed elements of the plan as part of the annual reporting requirements.

QUESTIONS

1. **What are your views on the proposed additional disclosure requirements listed above?**

   It is crucial to the success of TBPs that the possibility of fluctuations in benefits be made clear to members in plain language, free of legalese. DC plans have received wide acceptance from members, in spite of the unpredictability of benefits, precisely because the "pension deal" is eminently clear to members. Some Multi-Employer Plans (MEPs) that have been forced to reduce benefits have faced a very negative response from members because the possibility, and even the probability, of a reduction was never clearly communicated.

   In recognition of the risk to member benefits associated with TBPs, we agree that enhanced disclosure requirements are appropriate. In addition to the list provided, consideration should be given to requiring the disclosure of testing results for the probability test. Members should be told how secure their base and ancillary benefits are at each valuation cycle. In cases where a benefit reduction has been delayed (assuming our three-year rule is adopted), members should be informed in advance that such reduction will be necessary unless the funded situation improves sufficiently.

2. **What are your views on the timing, frequency, and sequence for communicating these additional disclosure items?**

   We believe that communication should be on an annual basis for most items, and following actuarial valuations if those are not on annual cycles. Timing could be within nine months of the plan year end.

3. **What are your views on requiring the plan administrator to report the solvency funding ratio of the plan in its annual reports for informational purposes only?**

   Current CIA standards would require such disclosure in the valuation report and we see no reason why this ratio should not be disclosed to members.

CONVERSION OF PENSION PLANS TO TARGET BENEFIT PLANS

As conversion from a DB plan to a TBP would require consent from plan members and retirees, rules which outline the conversion process for DB plans are necessary. In the context of federally-regulated TBPs, conversion rules for DB plans would outline the method by which the existing pension benefit credits held by active plan members and pension benefits owed to retirees would be carried over to the TBP model in the event of conversion.

CONSIDERATIONS

ALLOWING FOR BENEFIT ADJUSTMENTS

As conversion from a DB plan to a TBP could result in adjustments in benefits, the federal framework would need to accommodate benefit adjustments in this context.

FUNDING DEFICITS UPON CONVERSION

The federal TBP framework must also include a mechanism that addresses existing funding deficits upon conversion, as TBPs may be an option for federally-regulated DB plans facing solvency funding shortfalls and sustainability challenges. Although the funding rules would not require solvency funding, plans would be required to maintain going-concern funding. DB plans running a going-concern deficit at the time of conversion would need to become fully funded for the TBP model to operate effectively.

ACCRUED BENEFITS

When converting to a TBP, one must consider how benefits accrued under the pre-conversion pension plan are treated. If all accrued benefits at the time of conversion are considered to be part of the “base” benefits going forward (as opposed to ancillary benefits), all accrued benefits at the time of conversion are the least likely to be reduced under the funding deficit recovery plan. The federal regime would also need to outline how accrued benefits are to be treated and how the value of this accrued benefit would be established for the conversion.

PROPOSED APPROACH

It is proposed that the conversion provisions allow for a reduction in accrued benefits so as to accommodate federally-regulated DB plans that, through consent from employees and retirees, are seeking conversion to a federally-regulated TBP.

The federal framework would require that plans be fully funded on a going-concern basis upon conversion (taking into account changes to plan provisions such as benefit reductions). Any going concern deficit would be required to be made up by the employer at the time of conversion. The federal framework would also require that all accrued benefits at the time of conversion be considered “base” benefits, which can be reduced. Future indexation for retirees would be considered an ancillary benefit.

As discussed in sections 4.3 Contributions and 4.11 Termination and Wind-up, to ensure that federally-regulated DB plans do not seek to convert to a federally-regulated TBP so as to terminate under federal TBP rules (to avoid solvency funding requirements upon wind-up), under the proposed legislation/regulations, plans terminated within 5 years of conversion would be subject to existing termination rules for DB plans governed by the PBSA.

Conversion from a federally-regulated DC plan to a TBP would also be possible under the federal regime. In this case, the value of assets accumulated under the DC plan would determine an employee’s accrued benefits upon conversion.

QUESTIONS

1. **What are your views on how benefits are treated upon conversion?**

   We believe that nominal dollar amounts of pension and the terms of eligibility (i.e., age and / or “points” rules) accrued up to the conversion date should be preserved and deemed base benefits under TBP legislation. Future increases in those benefits, however (due to future salary increases for active members and future indexing for retirees), should be capable of being deemed ancillary benefits upon conversion. Alternatively, such increases could be classified as base benefits, recognizing that this classification would then increase the level of future contributions required to satisfy the minimum benefit security level. This is consistent with both the NB and PEI approaches to TBP conversion practices and preserves accrued pension amounts upon conversion.

   We believe that plan sponsors should have the ability to convert past service DB or DC benefits as part of the process of effectively introducing TBPs, subject to strict funding and risk management requirements similar to SRPs in NB. However, plan sponsors who are able to successfully negotiate a conversion with their members and receive the requisite member consent should be able to design a TBP with less rigid risk management and funding requirements.

2. **Do you have any other views on how accrued benefits should be calculated at the time of conversion?**

   Our response to this question is fully covered in #1, above.

3. **What views, if any, do you have on converting federally-regulated DC plans to TBPs?**

   We believe conversion from DC to TBP should be permissible and see this as very analogous to conversions from DB to DC that took place in the past. The arrangement for future service is straightforward and would be identical to a newly established plan. The conversion of past benefits could be allowed but should be subject to individual member choice. This is because some former DC members may be able to generate a greater benefit from their DC balance at the time of conversion than the benefit they would receive under the new TBP. The price of conversion from DC to TBP benefit would have to be established such that the plan satisfies applicable risk management criteria after the conversion and would likely require that the price of conversion benefits be closely related to the initial open group funded level of the plan.

PORTABILITY AND LOCKING-IN RULES

The PBSA and its regulations include rules that provide for the locking-in of a member's pension benefits and provide for limited circumstances under which funds can be withdrawn from the plan. The PBSA also sets out the rules for the portability of the portion of the plan's assets attributed to a member, i.e., the pension benefit credit, to another pension plan or another retirement saving or retirement income vehicle.

The current PBSA provisions for federally-regulated DC and DB plans applicable to the locking-in of a plan member's contributions and the calculation and portability of the member's pension benefit credit would apply in the context of federally-regulated TBPs. As a result the same conditions would apply and the same options would be available for the transfer of funds out of a TBP.

QUESTION

1. **Are there any TBP-specific issues in relation to locking-in and portability that should be addressed in the federal legislative and regulatory framework?**

   We observe that the portability and locking-in provisions for DB and DC plans currently are consistent and see nothing in the move to a TBP structure that would require modification to the existing regulatory framework.

INDIVIDUAL TERMINATION

The TBP framework must address situations where an individual seeks to terminate their employment and transfer their assets out the plan.

CONSIDERATIONS

Benefits under the proposed federal TBP framework are “target” rather than “defined” or “guaranteed” as they are under a DB plan and, as a result, plans would not be required to be funded on a solvency basis. For that reason, one cannot use the same discount rate used to determine the accrued value of a pension benefit due to an individual who seeks to terminate their employment and transfer their assets out of the plan as would be used for a DB plan. Instead, an alternative method must be used that reflects the benefit provided under the TBP.

An option would be to calculate the termination value for an individual employee by taking the target benefit accrued by the plan member at the time of termination, adjusted by the funded ratio of the plan as of the review date of the most recent valuation of the plan. The plan administrator could delay the calculation of the termination value until a new termination value is calculated if the plan administrator determines that the funded ratio has adjusted by more than 10 percent since the last valuation.

In determining a termination value one must consider any margin included in the funding model as discussed in section 4.2 Funding Policy. Inclusion or exclusion of this margin in the calculation of the termination value will have an impact on whether the terminating employee receives a share of the margin upon departure. In either case, when calculating a termination value, the same discount rate must be used to calculate the accrued value of the terminating employee’s target benefit as is used in the calculation which determines the funded ratio of the plan.

Under the proposed federal TBP framework, the value provided upon termination, referred to as the termination value, would be calculated following a method similar to the one described above.

The proposed federal model would require that the termination value be calculated by taking the accrued value of the individual’s target base benefit on a going-concern basis, adjusted by the funded ratio of the plan at the time of the most recent valuation. A revised valuation could be requested for this calculation if the plan administrator determines that the funded ratio has adjusted by more than 10 percent.

The proposed federal framework would require the individual’s accrued amount to be calculated using the normal retirement age and the same discount rate and other assumptions used to calculate the plan’s overall funding liabilities (including any margins applied to the discount rate). The decision to include buffer margins in the termination value calculation would be determined in the plan text.

Moreover, the proposed federal framework would allow for the funded ratio to exceed 100 percent in the calculation of an individual member’s commuted value (which would occur if the plan is in a surplus situation). As a surplus is built up to increase the likelihood of paying ancillary benefits, allowing for surplus to be included provides for the full value of ancillary benefits to be captured in the commuted value calculation.

QUESTION

1. What are your views on the methodology used to calculate the individual termination value?

The proposed methodology for calculating the individual termination value is appropriate. For clarity, the funded ratio should be measured on a closed group basis (i.e., excluding the present value of future contribution margins from plan assets). However, we would suggest that consideration be given to using a retirement age assumption in the termination value consistent with the most recent actuarial valuation of the plan, rather than assuming normal retirement age. (We concede that New Brunswick requires the assumption of normal retirement age for their termination value calculation, which is consistent with the proposed methodology.)

PLAN TERMINATION AND WIND-UP

As outlined under section 29 of the Pension Benefits Standards Act, 1985, the Office of the Superintendent of Financial Institutions (OSFI) can terminate a federally-regulated plan for any of the following reasons: (1) there is a cessation of employer contributions; (2) the employer is discontinuing its business operations; (3) OSFI is of the opinion that the plan has failed to meet any of its funding standards (i.e., solvency or going-concern): or, (4) there is a cessation of crediting of benefits to plan members. Alternatively, the plan administrator or employer may voluntarily terminate the plan by notifying OSFI in writing. In either case, as of the date of termination, there is to be no further crediting of benefits to the plan members under that pension plan.

Wind-up refers to the distribution of assets of a pension plan that has been terminated. The actual termination process may be lengthy and therefore there may be significant delays between the declaration of termination and the actual wind-up of a plan.

In the context of federal TBPs, termination and wind-up rules will determine the method by which a target benefit is calculated upon termination and how it would be distributed to plan members and retirees.

TERMINATION VALUE

- There is a cessation of employer contributions;
- The employer has discontinued or is in the process of discontinuing all of its business operations (or a part of its business in which a substantial portion of employees who are members of the pension plan are employed);
- There is a cessation of crediting of benefits to the plan members; or,
- OSFI believes the plan is no longer meeting going-concern funding standards.

It is proposed that the administrator could have the option to terminate the plan by indicating their intention to do so to OSFI in writing. The employer or administrator would be required to notify OSFI of their desire to terminate the plan not less than 60 days and not more than 180 days before the date of the termination or winding-up.

QUESTIONS

1. **What are your views on the formula used for calculating termination value? Would it be more appropriate to use the solvency funding ratio?**

   The termination value for members upon cessation of the TBP should be based on the going concern / funding basis rather than solvency. In doing so, the present value of future contributions would be ignored.

2. **What are your views on applying solvency requirements in the case of plan termination within 5 years of conversion from a federally-regulated DB plan?**

We agree that this approach makes sense as an anti-avoidance measure since it eliminates the ability of a plan to convert from DB to TBP to avoid the usual funding requirements upon DB plan termination. Consideration could be given to a period even longer than five years.

APPLICATION TO MULTI-EMPLOYER PLANS

QUESTIONS

1. **To what extent could the proposed elements of the federal TBP framework apply in a multi-employer context?**

   While MEPs have already addressed many of the issues that TBPs pose, we do believe that there are aspects of the TBP structure that may provide valuable structure in the MEP space (i.e., definition of base and ancillary benefits, standards for member communications, completion and reporting of probability testing, etc.). However, we would not see this as prescriptive for MEPs, but rather as considerations for potential adoption in the form of best practices.

2. **What elements of the plan design would need to be different from the single employer environment?**

   In recognition of the fact that they are coming from a different world, some of the minimum standards being considered for TBPs should not apply to MEPs (i.e., the 97.5% and 75% minimums). However, we would propose that reporting the results of a stochastic analysis should be considered for adoption as a best practice for MEPs.